No. 1052

In the Supreme Court of the United States

October Term, 1944

Santa Inez Company, a Corporation, Petitioner

v.

United States of America

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

INDEX

CITATIONS

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OPINIONS BELOW

The District Court wrote no opinion and its findings of fact and conclusions of law (R. 25–34) are not reported. The opinion of the Circuit Court of Appeals (R. 225–230) is reported in 145 F. 2d 667.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 29, 1944 (R. 231). A petition for rehearing was filed on December 27, 1944, and was denied on January 2, 1945 (R. 232). The petition for a writ of certiorari was filed on March 19, 1945. The jurisdiction of this Court is

invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, under Sections 22, 111, and 112 (b) (5) of the Revenue Act of 1934, a holder of certificates of deposit representing defaulted mortgage bonds of an insolvent corporation is taxable on the difference between the cost of the bonds and the larger value of his interest in the mortgaged property, when that property was sold to the bondholders' committee at public auction pursuant to a plan to transfer the property to a new corporation all of whose stock is distributed to the bondholders.

STATUTES AND REGULATIONS INVOLVED

These are set forth in the Appendix, *infra*, pp. 10–12.

STATEMENT

This is an action for the recovery of alleged overpayments of income, excess profits, and personal holding company taxes for the calendar year 1934. The facts found by the District Court (R. 25–34) may be summarized as follows:

On April 15, 1928, the Whitney Estate Company created an issue of $1,200,000 first mortgage bonds secured by real estate upon which was situated an office building in San Francisco, California. On April 15, 1933, the company defaulted in the payment of interest and of that part of the

principal maturing on that date. These defaults were never cured. On June 1, 1933, a bondholders' protective committee was formed. Holders of the bonds deposited them with the committee and received certificates of deposit therefor. (R. 26.) In January of 1934, the committee formulated a plan pursuant to which the trustees under the mortgage would cause the property to be sold at public auction; the property would be purchased by the committee for the benefit of the depositing bondholders, and, thereafter, the property would be transferred to a new corporation in exchange for all of its stock which would be distributed to the depositing bondholders (R. 27). Pursuant to a request by the committee, the trustee caused the sale of the mortgaged property at public auction on February 28, 1934, and the property was purchased by the committee. It was paid for by the application to the purchase price of the distributive share of the net proceeds which inured to the approximately 95 percent of the outstanding bonds held by the committee, and by the payment to the trustee in cash of the distributive share of the net proceeds which inured to the benefit of the nondepositing bondholders. (R. 27–28.)

On the date of the trustee's sale, February 28, 1934, the taxpayer owned certificates of deposit representing $136,000 principal amount of the bonds which it had purchased for $59,421.25. The

taxpayer's pro rata share of the fair market value of the mortgaged property on the date of its purchase by the committee was $104,328.95. (R. 28–29, 31.)

Due to the pendency of certain litigation, the committee did not obtain possession and clear title to the property until May 15, 1934. Thereafter, the committee proceeded with the plan to organize a new corporation and it (One Thirty-three Geary Corporation) was incorporated on September 4, 1934. The property was transferred to Geary on November 30, 1944, and all of its stock was issued to the committee for the benefit of the depositing bondholders. On December 10, 1934, the taxpayer received in exchange for its certificates of deposit 1,360 shares of this stock. (R. 28–29.)

In its original return for the calendar year 1934, the taxpayer reported no gain resulting from these transactions. In an amended return for that year, however, it reported as gross income the sum of $44,907.70 as capital gain realized at the time of the purchase of the mortgaged property by the committee. (R. 30–31, 218.) The taxpayer paid the taxes and interest resulting from the inclusion of this gain as income for the year 1934 (R. 31–32), and after filing a claim for refund which was not acted on for more than six months (R. 33), brought this suit for their recovery (R. 33). The District Court wrote no opinion

but held that the taxpayer was entitled to judgment (R. 24–36). The Circuit Court of Appeals reversed (R. 225–231).

ARGUMENT

1. Petitioner's primary contention is "that no taxable gain resulted from" the sale at public auction "because bondholders acquire the status of equitable owners of the mortgaged property on the date of the default if the debtor is in fact insolvent" (Pet. 10). But Article 23 (k)–3 of Treasury Regulations 86 (Appendix, *infra*, pp. ~~10–11~~ 11–12) provides, in part, that

> if the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property.

This provision has appeared in the Treasury Regulations since the enactment of the Revenue Act of 1926,[1] and has been applied in numerous

[1] Article 153 of Treasury Regulations 69; Article 193 of Treasury Regulations 74 and 77; Article 23 (k)–3 of Treasury Regulations 86, 94, and 101; Section 19.23 (k)–3 of Treasury Regulations 103; Section 29.23 (k)–3 of Treasury Regulations 111.

cases. *Commissioner* v. *West Production Co.*, 121 F. 2d 9 (C. C. A. 5th), certiorari denied, 314 U. S. 682; *Commissioner* v. *Spreckels*, 120 F. 2d 517 (C. C. A. 9th); *Helvering* v. *New President Corp.*, 122 F. 2d 92 (C. C. A. 8th); *Hadley Falls Trust Co.* v. *United States*, 110 F. 2d 887 (C. C. A. 1st); *Malden Trust Co.* v. *Commissioner*, 110 F. 2d 751 (C. C. A. 1st); and *Brown* v. *United States*, 95 F. 2d 487 (C. C. A. 3d).

As a result of the acquisition of the mortgaged property by the bondholders' committee, therefore, the taxpayer then acquired an interest therein worth \$104,328.95. This interest was acquired for certificates of deposit representing bonds which had cost the taxpayer \$59,421.25. Under Sections 22 and 111 (Appendix, *infra*, pp. ~~[illegible]~~ 10-11), and pursuant to the provisions of the Regulation above set out, a gain was realized by the taxpayer in that transaction, and since no provision of the statute directs that such a gain shall not be recognized, it was properly includible in gross income.

In neither *Helvering* v. *Limestone Co.*, 315 U. S. 179, nor *Helvering* v. *New Haven & S. L. R. Co.*, 121 F. 2d 985 (C. C. A. 2d), certiorari denied, 315 U. S. 803, rehearing denied, 315 U. S. 829, referred to by petitioner (Pet. 10), was it necessary to decide precisely when the bondholders' interest changed, for tax purposes, from that of a creditor to that of an owner. It was enough to decide that at some time prior to the exchange of

property of the old corporation for stock of the new, the bondholders had acquired a propriety interest in the property.[2] There was thus no need to refer to the Treasury Regulation which, we submit, is controlling in this case.

To be sure, as *Helvering* v. *Cement Investors*, 316 U. S. 527, held, the subsequent transfer of the property to the new corporation in exchange for its stock was a transaction falling within the nonrecognition provisions of Section 112 (b) (5) (Appendix, *infra*, p. ~~10~~ 11). But Section 112 (b) (5) deals only with the transfer of property to a corporation in ratable exchange for its stock. It has no effect upon, or relation to, the transaction pursuant to which the exchangers have themselves previously acquired the property. Those who transfer property to a corporation in a transaction falling within the scope of Section 112 (b) (5) may have acquired the property in any of various ways. The nonrecognition provided by Section 112 (b) (5) is of gain or loss resulting from the transfer of property to the corporation; the Section does not deal with the transaction, whatever its nature, whereby that

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[2] These cases involved the "reorganization" provisions of the revenue laws and raised questions which, as the opinion of this Court in *Helvering* v. *Cement Investors*, 316 U. S. 527, 530–534, expressly noted, are not the same as that here presented. Not only is there no claim in the instant case that the "reorganization" provisions are applicable, but it has been expressly conceded that they do not apply (R. 50).

property was acquired by the transferors. And it is such a prior transaction which gives rise to the tax here involved.

2. Following the decisions of this Court, in 1942, in the *Limestone* and companion cases [3] and the *Cement Investors* case, the field was canvassed by Congress and the entire subject, insofar as Congress deemed it necessary, has now been covered by statute. Section 121 of the Revenue Act of 1943, Public Law 235, 78th Cong., 2d Sess. It is true, as the petitioner states (Pet. 11), that these new statutory provisions apply only to cases where an insolvent corporation is reorganized pursuant to a court-approved plan. This, however, seems only to indicate that Congress did not believe that there was any practical necessity for legislative treatment beyond that point. We are informed by the Bureau of Internal Revenue, moreover, that the question here presented is involved in only eight cases pending in the various field offices, together with one pending in the Tax Court and one pending in a district court.

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[3] *Palm Springs Corp.* v. *Commissioner*, 315 U. S. 185; *Bondholders Committee* v. *Commissioner*, 315 U. S. 189; *Helvering* v. *Southwest Corp.*, 315 U. S. 194.

CONCLUSION

The decision below is correct. There is no conflict and the ruling of the court below seems to be one, not of general importance, but of comparatively narrow application. The petition should therefore be denied.

Respectfully submitted.

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APRIL 1945.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(e) *Determination of Gain or Loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111.

* * * * *

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount real-

ized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

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SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * *

(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * *

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

> ART. 23 (k)-3. *Uncollectible deficiency upon sale of mortgaged or pledged property.*— * * * In addition, if the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obliga-

tions constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property. The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer in the absence of clear and convincing proof to the contrary. If the creditor subsequently sells the property so acquired, the basis for determining gain or loss is the fair market value of the property at the date of acquisition.

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